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No. 384.

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CHARLES ELMORE CROPLEY

IN THE

Supreme Court of the United States

OCTOBER TERM, 1949.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CHRISTIAN W. KORELL,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR RESPONDENT.

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BRIEF FOR RESPONDENT.

Opinions Below.

The findings of fact and opinion of the Tax Court (R. 9-14) are reported in 10 T. C. 1001. The original opinion of the Court of Appeals (R. 16-21) and the *per curiam* opinion of the Court of Appeals on re-hearing (R. 31-32) are reported in 176 F. 2d 152.

Jurisdiction.

The judgment of the Court of Appeals was entered June 8, 1949 (R. 21). A petition for re-hearing was denied July 14, 1949 (R. 33). The petition for a writ of certiorari was filed on October 11, 1949, and the writ was granted on December 5, 1949 (R. 34). Jurisdiction is conferred on this Court by 28 U. S. C. Section 1254.

Question Presented.

The question presented is whether the Tax Court and the Court of Appeals correctly held that respondent was entitled, under Sections 23(v) and 125 of the Internal Revenue Code, to deduct from his 1944 gross income an amount of $8,638.75 as amortization of the premium paid upon the purchase in that year of certain convertible bonds of American Telephone and Telegraph Company.

Statute and Regulations Involved.

The provisions of the Internal Revenue Code and Treasury Regulations involved are set forth in the Appendix, *infra*, pp. 29-35.

Statement.

The facts as stipulated and as found by the Tax Court (R. 2-10) are briefly as follows:

Respondent, an individual, filed his income tax return for the period in question with the Collector of Internal Revenue for the Second District of New York (R. 9).

During 1944 respondent purchased $50,000 principal amount of American Telephone and Telegraph Company 15-year 3 per cent convertible debenture bonds, due September 1, 1956, as follows (R. 9):

August 16, 1944	$11,000 at 121⅛	$13,351.25
August 16, 1944	2,000 at 121	2,425.00
August 22, 1944	37,000 at 121¼	44,862.50

The average market price of the capital stock of the American Telephone and Telegraph Company on August 16, 1944, was $163.1875 per share, and on August 22, 1944, was $163.6875 per share (R. 9).

These bonds were issued under an indenture between American Telephone and Telegraph Company and City Bank Farmers Trust Company, Trustee, dated September 1, 1941.[1] The indenture provided in part (Section 3.01 (R. 4)) that on not less than thirty days' notice the bonds might be redeemed by the Company in whole or in part on any date on or after September 1, 1942, "at the following redemption prices (expressed in percentages of the principal amount) together with accrued interest to the date fixed for redemption: to and including August 31, 1944, 107%; thereafter to and including August 31, 1948, 104%; thereafter to and including August 31, 1953, 102%; and thereafter 100%" (R. 9-10).

The indenture further provided (Section 4.01 (R. 4-5)) that the holder of any debenture bond "shall have the right, at his option, at any time after January 1, 1942, to and including December 31, 1954 (except that, in case any Debenture Bond or Debenture Bonds shall be called for redemption before such latter date and payment thereof duly provided for, such right shall terminate at the close of business on the date fixed for redemption of such Debenture Bond or Debenture Bonds) to convert * * * the principal of any such Debenture Bond * * * into such number of full-paid and non-assessable shares of Capital Stock of the Company as the principal amount of the Debenture Bond * * * surrendered for conversion is a multiple of $100 * * * at the price of $140 per share * * *," by the surrender of $100 principal amount of debenture bonds and payment to the Company of cash equal in amount to the excess of the conversion price over $100 (R. 10).

The entire issue of these bonds was called for payment under the provisions of the indenture as of September 1, 1947, at 104, plus interest (R. 10).

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[1] Only the material provisions of the indenture, an exhibit to and a part of the stipulation of facts (R. 3), are printed in the Record. The complete indenture has been filed with the Court.

These bonds were the only premium bonds purchased or owned by respondent in 1944. They were not part of the stock-in-trade of respondent or includible in any inventory of respondent at the close of the taxable year, or held by him primarily for sale to customers in the ordinary course of his trade or business, but were purchased by respondent as an investment (R. 10).

Respondent, in 1944, did not sell any of the bonds or exercise his right of converting them into capital stock of the Company (R. 10).

In his return for the taxable year (1944) respondent claimed as a deduction, in computing net income, amortization of the premium paid with respect to his bonds in the amount of $8,638.75 representing the difference between $60,638.75—the cost of the bonds—and $52,000—the call price of the bonds at 104 (R. 10).

The Commissioner disallowed the deduction of $8,638.75 and determined a deficiency. The Tax Court reversed the Commissioner and in a decision reviewed by the entire Court unanimously held (R. 9-15) that said amount of $8,638.75—the difference between the cost of the bonds and their earliest call price—was "amortizable bond premium" under Section 125 of the Internal Revenue Code and deductible from respondent's gross income under Section 23(v) of the Code. The Court of Appeals affirmed the decision of the Tax Court (R. 16-21) and denied the Commissioner's petition for re-hearing (R. 31-33). The Court of Appeals agreed that the excess of cost of the convertible bonds here in issue over their earliest call price was "amortizable bond premium" within the meaning of the statutory provisions (R. 16-21, 31-33).

Summary of Argument.

Section 125 of the Internal Revenue Code clearly and without ambiguity defines the term "bond premium" as the excess of the basis of a bond (in this case cost) over the amount payable on maturity or on earlier call date. This statutory definition, adopted by petitioner himself in his regulations, expresses the true intent of Congress as evidenced by the Committee Reports and the testimony of witnesses before the Congressional Committees. The definition of the term "bond premium" set forth in Section 125 to include any premium paid on the purchase of a bond without reference to one or another of the various factors which cause the premium to exist, is in accord with the common understanding of that term. There is no support either in the statute and its legislative history or in the common understanding of the term "bond premium" for petitioner's contention that only an amount paid to obtain a higher rate of interest is "true bond premium" subject to amortization. Neither is there any support for the corollary of that proposition—that where "true bond premium" exists the value of the bond will decrease as the call or maturity date approaches. The amount of bond premium determined in accordance with Section 125 of the Internal Revenue Code is "true bond premium" and is properly deductible under Section 23(v) of the Code.

In deducting in his 1944 income tax return as "amortizable bond premium" the amount of $8,638.75, representing the difference between the cost of the convertible bonds here involved and their earliest call price, respondent fully complied with the provisions of Section 23(v) and 125 of the Internal Revenue Code and the regulations thereunder.

Section 125 is applicable to bonds convertible into stock of the issuing corporation, as is plainly demonstrated by the broad language of the statute itself and its legislative history.

ARGUMENT.

POINT I.

The only issue presented is the meaning of the term "bond premium" as set forth in Section 125.

In 1944 respondent purchased as an investment $50,000 principal amount of American Telephone and Telegraph Company 15-year 3% Convertible Debenture Bonds due September 1, 1956 at a price of approximately 121% of par. At that time the bonds were subject to call at any time upon thirty days' notice at 104%. The bonds were also convertible at the option of the holder into stock of the company upon the surrender of $100 principal amount of a bond and the payment of $40 in cash in exchange for each share of stock. In his income tax return for 1944 respondent deducted, pursuant to Sections 23(v) and 125 of the Internal Revenue Code (Appendix, *infra*, pp. 29-31), as amortizable bond premuim the amount of $8,638.75 being the difference between the purchase price of the bonds and the then call price of 104%.

The petitioner concedes that if said amount of $8,638.75 is bond premium within the meaning of Section 125, the full amount thereof is deductible under Sections 23(v) and 125 as amortizable bond premium (Pet. Br., p. 5; R. 20, 29). However, because the bonds carried a conversion privilege petitioner seeks to deny the deduction on the ground that

the premium was not "true bond premium" within the meaning of the statute—that "true bond premium" is only that amount paid to obtain a higher rate of interest. The petitioner would here brush aside the plain language of the statute and of the Reports of the Congressional Committees which clearly show that Congress defined bond premium in broad terms as simply the difference between the cost of the bond and the amount payable at maturity or earlier call date. This statutory definition is not limited or restricted and in no way depends upon the presence or absence of any particular factor which may have caused the premium to exist. Petitioner would substitute for this clear statutory definition a vague, indefinite and elusive rule which would restrict the broad statutory definition and make it inoperative unless the premium were caused solely by the interest factor. He would have this Court disregard the mandatory statutory definition which correctly recognizes that many factors, in addition to the interest rate, influence the price of bonds and cause them to sell at a premium. Petitioner bases his entire argument upon an unsupportable assumption—that only a premium paid to obtain a higher rate of interest is "true bond premium" subject to amortization under Section 125.

The Tax Court in a decision reviewed by the entire Court (R. 10-14) rejected petitioner's contention for the reason that it conflicted with the plain statutory definition and ignored the interpretation which Congress itself placed upon the statute (R. 14). In affirming the Tax Court, the court below in its original opinion likewise declined to limit and restrict the term "bond premium" as urged by petitioner, and held that the statute provides a complete scheme applying in general terms to all forms of bonds, including callable and convertible bonds (R. 19). The

court below properly was of the opinion that to attempt to make the distinctions urged by petitioner in a statute so broadly worded would "be trespassing beyond the judicial, and upon the legislative, process" (R. 21).

Petitioner's contention that statutory "bond premium" represents only an amount paid to obtain a higher rate of interest was again rejected by the court below on rehearing as being unwarranted by the broad statutory language and at variance with its legislative history (R. 31-33).

The uncontested facts of this case (R. 2-3, 9-10) show that respondent has complied fully with all of the applicable provisions of the statute and regulations.

As evidenced by the conflict between the decision of the court below and the decision of the Court of Appeals for the Ninth Circuit in *Commissioner* v. *Shoong*, 177 F. 2d 131 (pending on petition for a writ of certiorari, No. 453, this Term), the sole question presented to this Court is whether the clear statutory definition of the term "bond premium," as set forth in Section 125 of the Internal Revenue Code, is to prevail, or whether the characterization by petitioner of such premium as "true" or "not true" is to be the uncertain standard with which the taxpayer must comply at his peril. Therefore an affirmance herein does not require the Court to say that the statute "should be construed so as to permit the outright purchase of a tax deduction" (Pet. Br. p. 9), or to sanction a tax avoidance device (Pet. Br. p. 15).

POINT II.

The statute and the regulations clearly define the excess of the amount paid for the bonds here involved over call price as "bond premium". The statutory definition of "bond premium" expresses the Congressional intent.

Petitioner's contention that "bond premium" is not defined by the statute but represents only the amount paid to obtain a higher rate of interest (Pet. Br. pp. 12, 25) is squarely met by the statute itself which clearly prescribes the method of determining the existence and amount of bond premium and the amortizable amount thereof which is deductible in the taxable year. It is not necessary to look beyond the four corners of the statute which "still remains the best indicator of the legislative intent" (R. 18) to determine what is bond premium which is subject to amortization.

It is well settled that the intention of Congress is to be sought primarily in the language used and that where the statutory language is clear and unambiguous there is no room for construction.

Helvering v. *City Bank Farmers Trust Co.*, 296 U. S. 85, 89;
Osaka Shosen Kaisha Line v. *U. S.*, 300 U. S. 98, 101;
Thompson v. *U. S.*, 246 U. S. 547, 551;
Caminetti v. *U. S.*, 242 U. S. 470, 485;
Packard Co. v. *Labor Board*, 330 U. S. 485, 492;
United States v. *Rice*, 327 U. S. 742, 753.

See also:

Forrestal v. *Commissioner* (2nd Cir.), 120 Fed. (2d) 223, 225.

The scheme of Section 125 is remarkably simple and concise although wholly complete. It states in unequivocal terms that

> "* * * *the amount of bond premium*, in the case of the holder of any bond, *shall* be determined with reference to the amount of the basis * * * of such bond, and with reference to the amount payable on maturity or on earlier call date, * * *." (Subsection (b)(1), Appendix, *infra*, p. 30.) (Italics supplied.)

and that

> "The amortizable bond premium of the taxable year *shall* be the amount of the *bond premium* attributable to such year." (Subsection (b)(2), Appendix, *infra*, p. 30.) (Italics supplied.)

Hence, the amount of the bond premium in this case is determined by reference to the amount of the basis of the bonds (cost $60,638.75) and with reference to the amount payable on the earlier call date ($52,000). The amortizable bond premium of the taxable year (1944) was the amount of the bond premium attributable to such year. Since the earliest call date occurred in 1944, the year of purchase, the amount attributable to that year was the entire bond premium of $8,638.75. This method of computation is not disputed by petitioner. (Pet. Br. p. 5; R. 20, 29.)

The language of subsection (b)(1) is mandatory and provides only two guideposts for determining the amount of bond premium—the cost of the bond and the amount payable at maturity or earlier call date. In accordance with the plain language of subsection (b)(1) of Section 125, bond premium is simply the difference between the cost of the bond and the amount payable on maturity or on earlier call date. At the time of the enactment of Section 125 the petitioner entertained none of the doubts

which now beset him that this statutory definition of bond premium is correct and fully expressive of the intent of Congress. In his own regulations the Commissioner (§29.125-2, Regulations 111; Appendix, *infra;* p. 33) defined "bond premium" in exact conformity with the statute as follows:

> "Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date."

The above provision of the regulations, which was relied upon by respondent in computing the deduction for amortizable bond premium is still in full force and effect and has not been modified in any respect by the petitioner. The regulations contain none of the qualifications or restrictions that petitioner now urges nor, as pointed out by the Court below, "does petitioner suggest any definition of his concept of sufficient precision so that it could safely be relied on by taxpayers or revenue enforcing authorities hereafter" (R. 20).

In this case, the bonds were subject to call during the taxable year. Therefore the entire amount of bond premium was attributable to the taxable year 1944 and was properly deducted by respondent in his income tax return for that year. The correctness of this computation is conceded by petitioner (Pet. Br., p. 5; R. 20, 29).

That the statutory definition of "bond premium" as the difference between the cost of the bond and the amount payable at maturity or earlier call date—without regard or reference to the various factors which may have caused the premium—expresses clearly and without ambiguity the intent of Congress is undeniable. This is demonstrated by

the Reports of the House Ways and Means and Senate Finance Committees accompanying the Revenue Act of 1942 wherein it is said:

> "The terms 'bond premium' and 'amortizable bond premium,' as used in this section, refer to different amounts. Bond premium, in the case of any bond subject to this section, is the total premium thereon; that is, the excess of the basis of the bond for determining loss over the amount payable at maturity. On the other hand, amortizable bond premium is such part of the total premium on the bond as is attributable to the taxable year.
>
> "H. Rep. No. 2333, 77th Cong., 2nd Sess., p. 79 (1942-2 CB 372, 432); S. Rep. No. 1631, 77th Cong., 2nd Sess., p. 93 (1942-2 CB 504, 574-575)."[2]

Congress could have used no plainer words to express its intent than those contained in the foregoing statement. Moreover, the Committee Reports make it perfectly clear, as above stated, that "amortizable bond premium" under subsection (b)(2) of Section 125 is merely an amount computed by reference to the total "bond premium" determind in accordance with subsection (b) (1) thereof. The Committee Reports in referring to callable and convertible bonds further state that "the total premium is required to be spread over the period from the date as of which the basis of the bond is established down to the earliest call date, rather than down to the maturity date."[3] Therefore there is no validity to petitioner's assertion (Pet. Br., pp. 25-26) that subsection (b)(1) "merely states the *method* of computing the amount of the premium" rather than a definition of "bond premium".

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[2] Petitioner fails to cite or refer to this portion of the Committee Reports in his brief.

[3] *Infra*, p. 26.

The above statement of legislative intent embodied in the Committee Reports, the clear and unequivocal language of the statute itself, and the equally clear provisions of the Commissioner's regulations leave no uncertainty that bond premium for the purposes of Section 125 is simply the difference between the cost of the bond and the amount payable at maturity or earlier call date. Here the plain words of the statute are in no danger of being overcome "by a legislative history which, through strained processes of deduction from events of wholly ambiguous significance, may furnish dubious bases for inference in every direction." (*Gemsco, Inc.* v. *Walling*, 324 U. S. 244, 260). Rather, the legislative history of Section 125 serves quite the opposite function of strengthening the ordinary meaning of the statutory language.

In addition to the plain language of the statute itself, the Commissioner's own regulations, and the statements contained in the Committee Reports, there is ample evidence in the testimony of witnesses appearing before Congressional Committees that Congress, with full awareness, intended that the term "bond premium" for purposes of Section 125 should be the difference between cost and the amount payable on maturity or earlier call date regardless of whether the premium is caused in whole or in part by a conversion privilege. Nothing in the statute, the regulations, the Committee Reports, or the testimony of witnesses at Committee hearings on the Revenue Act of 1942 lends any support to the proposition that the term "bond premium" is limited to an indefinite sum representing a theoretical calculation of the amount paid to obtain a higher rate of interest.

From the testimony of Mr. Roy C. Osgood, Vice-President of the First National Bank of Chicago, in charge of its Trust Department, it is apparent that Congress was fully

apprised that in the case of callable and convertible bonds the premium might be the result of the conversion privilege. (Vol. 3 Hearings Before House Ways and Means Committee, 77th Cong., 2d Sess. on Revenue Revision of 1942, pp. 2826-7; Vol. 2 Hearings Before Committee or Finance, U. S. Senate, 77th Cong., 2d Sess. on H. R. 7378, pp. 1723-4, 1728-9).

Mr. Osgood was opposing the enactment of Section 125 because in his opinion the passage of the section would create difficulties in trust administration. His testimony names various bond issues, including issues of callable bonds and one issue of bonds both callable and convertible, all of which are cited as typical examples and not as isolated cases. To illustrate his point, Mr. Osgood cited before the Senate Finance Committee the issue of Commonwealth Edison Convertible Debentures, 3½'s, due July 1, 1958, callable at any time at 102¾ upon thirty days' notice. Pointing out that these bonds were then quoted at 110, the witness, at page 1729, raised the following questions:

> "Does the purchaser amortize the premium over call of 7¼ points within 30 days after purchase and do likewise in the case of innumerable other bonds selling above call which are also redeemable any time on 30 days' notice?
>
> "Suppose the purchaser of Commonwealth Edison 3½'s immediately writes his cost down to 102¾, and *on account of the conversion feature* within a reasonable time the bond duplicates the price of 131 at which it sold in 1940. If he sells at that price must he pay a tax on his theoretical profit of 28¼ points or on his actual profit of 21 points?" (Italics supplied).

This testimony makes it clear that Congress in enacting Section 125 was fully aware of the existence of numerous bonds which are both callable and convertible, and that the

conversion privilege might well cause fluctuations in the selling prices of bonds and be a factor in determining the amount of the premium. This testimony also brought out very clearly that in the event of a sale of the Commonwealth Edison bonds referred to therein at a price in excess of the call price of 102¾ (the original cost of 110 reduced by the deduction for amortization) a capital gain would be realized which would, at least in part, have resulted from the amortization deduction. In the example given by Mr. Osgood the capital gain would have been 28¼ points and this would have included the entire amortizable bond premium of 7¼ points.[4] If the bonds had been held for more than six months only one-half of this gain of 28¼ points would be taken into account for tax purposes pursuant to the provisions of Section 117(b) of the Internal Revenue Code (footnote 7, *infra*, p. 24).

The very situation which petitioner characterizes as "one of the most striking tax avoidance devices as yet propounded" (Pet. Br., p. 19) and "an apparently clear-cut tax windfall device" (Pet. Br., p. 9) was plainly disclosed to the Senate Finance Committee at the hearings on the Revenue Act of 1942. The interrelation of the various sections of the Internal Revenue Code was certainly well known to the Congressional Committees and the Treasury experts and it cannot be said that they were not cognizant of the fact that a deduction for amortizable bond premium might in the case of a later sale of the bond become a taxable capital gain subject to the percentage limitations provided by Section 117 of the Internal Revenue Code. Nonetheless, in defining "bond premium" in Sec-

[4] In accordance with the provisions of Section 125(a) (3) (Appendix, *infra*, pp. 29, 30) of the Internal Revenue Code the cost of the bonds in the above example is required to be reduced pursuant to the provisions of Section 113 (b) (1) (H) of the Internal Revenue Code (footnote 6, *infra*, p. 23).

tion 125(b)(1) and in the Committee Reports, Congress did not in any way attempt to limit or restrict the definition to exclude a premium resulting from a conversion privilege or any other particular value-creating factor. Instead, Congress clearly stated that bond premium for which an amortization deduction is allowable is in all cases the excess of the cost of the bond over the amount payable at maturity or earlier call date.

The testimony of Mr. Randolph Paul, Tax Advisor to the Secretary of the Treasury (Pet. Br., p. 15; R. 27-28) and the portion of the Committee Reports quoted by petitioner (Pet. Br., p. 13) are not pertinent to the issue herein and give no support to the contention that the "bond premium" for which a deduction was provided is only the amount paid to obtain a higher rate of interest. Mr. Paul's statement is not addressed to the meaning of the term "bond premium," nor does it refer to the various factors which might cause a bond to sell at a premium. It simply states that where a premium is paid, the purchaser realizes an effective yield less than the actual interest rate and that the difference between yield and interest rate is a return of capital; that "yield rather than the actual interest rate reflects the true income to the taxpayer." Since the "yield" can only be determined by reference to the amortization period and the amount of the premium paid, it is apparent that Mr. Paul's statement assumed the existence of a premium and a definite amortization period and that it was, therefore, unnecessary for him to consider the various factors causing a bond premium. Nowhere in his statement does Mr. Paul indicate that he had in mind any definition of "bond premium" other than that clearly set forth in the statute and the Committee Reports.

The portion of the report of the Ways and Means Committee quoted by petitioner (Pet. Br., p. 13) likewise does

not support petitioner's contention and contains nothing which would limit the broad statutory definition of bond premium simply to that amount paid to obtain a higher rate of interest.

The testimony before the Senate Finance Committee of Mr. John O'Brien of the Office of the Legislative Counsel, to which petitioner refers (Pet. Br., pp. 16-18), fully supports respondent's view that "'bond premium" is simply the difference between cost and the amount payable at maturity or earlier call date. At one portion of his testimony Mr. O'Brien recites the case of a bond purchased for $110 on which the taxpayer gets $100 on redemption, and concludes that "That $10 is bond premium." The balance of the testimony of this witness quoted in petitioner's brief, if at all relevant to the within issue, does not support the contention urged by petitioner.

POINT III.

The statutory definition of bond premium is in accord with the generally accepted meaning of that term.

In urging that bond premium is only that amount paid to secure a higher rate of interest, the petitioner is asking this Court to adopt a narrow and restricted definition of that term which not only conflicts with the plain language of the statute and its legislative history, but is at variance with the generally accepted meaning of that term.

The court below pointed out that "this restricted meaning of 'premium' is definitely rejected in the law of trusts • • • where the general idea of amortization has had perhaps its most extensive development in the law. Thus where amortization is required, a trustee is expected to

restore to principal the excess amount he has expended, not some lesser theoretic amount resting on an unknown variable such as the assumed normal rate of interest on money. 1 Restatement, Trusts, §239, comment f, 1935; 2 Scott on Trusts, §239.2, 1939; 4 Bogert, Trusts and Trustees, §831, 1935" (R. 32).

The court further said that: "from the time of Holmes on, the idea that the premium is paid solely for interest above the market rate has been attacked as clearly a fiction. *Hemenway* v. *Hemenway*, 134 Mass. 446, 449; *New England Trust Co.* v. *Eaton*, 140 Mass. 532, 544, 545; 4 N. E. 69, 77, 78; 45 *Yale L. J.* 156; 20 *Minn. L. Rev.* 203; 34 *Mich. L. Rev.* 448" (R. 32).

In common understanding the term "bond premium" is the excess of the purchase price over the amount payable at maturity or earlier call date.

"When bonds sell at a price greater than par, they are said to sell at a premium . . ." J. I. Bogen, Editor, Financial Handbook, 3rd Ed., The Ronald Press Company, New York, 1948, p. 1210. Also in Grossman, Investment Principles and Practice, Longman's Green & Co., New York, 1939, it is said at page 14: "Very frequently bonds sell in the market at a price in excess of the face value or at a *premium*." (Italics supplied).

See also:

Montgomery's Federal Taxes—Estates, Trusts and Gifts—The Ronald Press Company, New York, 1949-50, p. 148;

Chamberlain & Edwards, The Principles of Bond Investment—Revised and Enlarged Edition, 1927, p. 75;

Prime, Investment Analysis, p. 107—Prentice-Hall, 1946.

It may be assumed that Congress used the words "bond premium" in Section 125 to express their usual and ordinary meaning.

Crane v. *Commissioner*, 331 U. S. 1, 6;
United States v. *Warts*, 303 U. S. 414, 417;
Woolford Realty Co. v. *Rose*, 286 U. S. 319, 327.

It is also commonly understood and generally accepted that while the interest factor, namely the condition of the money market, is an element that influences bond prices, it is by no means the sole factor. Other factors which enter into the placing of a premium on a bond are (a) the credit standing of the issuing company; (b) the security of the bond issue; (c) the maturity of the bond; (d) whether such bonds are convertible or callable; and (e) the redemption price. See J. I. Bogen, Editor, Financial Handbook, 3rd Ed., The Ronald Press Company, New York, 1948, p. 1211. In 4 Bogert, Trusts and Trustees, cited above, the author says in §831:

> "* * * It can be said with much force that many factors enter into the placing of a premium on a bond. The interest rate of the bond in question, the general money market, the maturity of the bond, features of advantage aside from interest (such as convertibility), security of payment of interest and principal, marketability, etc., all may cause a premium to be paid on a bond in some cases. * * *. It is impossible to separate out the amount of premium paid for this element of advantage or that."

The assertion of petitioner that the premium on any bond depends solely upon the rate of interest (Pet. Br., p. 16) and the corollary of that proposition (Pet. Br., p. 18) that "the value of the bond would decrease by the

mere passage of time, as the call or maturity date approached and the premium (which depends upon the rate of interest and the period during which the interest remains to be paid) "diminished" are readily disproved. Were interest the sole factor then, as urged by petitioner, the premium would decrease with mathematical exactitude and regularity as the maturity or call date of the bond approached. But reference to the behavior of bonds in the open market, even where the bonds carry no conversion privilege and are not immediately callable, discloses that prices may actually increase, rather than decrease, as the maturity date approached.

For example, the following bonds, all of which were non-convertible and not currently callable, fluctuated in price during the 10-year period 1935 to 1944 and actually increased in price as the maturity date approached,

	High	Low
Bell Telephone of Pennsylvania 5's, C, 1960 (Callable at par on October 1, 1957)	137¼ (1941)	116¾ (1935)
Capital Traction Company 1st 5's, 1947	110 (1944)	61 (1938)
Texas Power & Light Company Deb. 6's, 2022 (Callable at 110 on July 1, 1947)	121¾ (1940)	83½ (1935)

Would petitioner say that a purchaser of the non-callable and non-convertible Bell Telephone bonds in 1941, who paid a price 37¼ points above par, did not pay a "true bond premium" because the price of the bonds did not diminish as

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[5] Moody's Public Utilities, 1945, Special Features Section, pp. a 62 et seq.

the maturity date approached? Yet that is exactly what petitioner says in this case when he urges the Court to hold that "true bond premium" is only that premium which is paid to obtain a higher rate of interest, and which premium diminishes with the mere passage of time.

This Court itself has recognized that factors other than interest may determine prices at which bonds are sold and that bond prices do not necessarily decline as the maturity date approaches. In *New York Life Insurance Co. v. Edwards*, 271 U. S. 109, decided prior to the Revenue Act of 1942, the Court disallowed a deduction for amortization of bonds purchased at prices above par, but pointed out at page 116 that "All of the securities might have been sold thereafter above cost."

POINT IV.

Respondent has complied fully with all the applicable provisions of the statute and regulations and is entitled to the deduction.

Petitioner concedes that the American Telephone and Telegraph Company bonds are "bonds" within the meaning of the statute (R. 29). Furthermore, the uncontested facts of this case (R. 2-3, 9-10) demonstrate respondent's complete compliance with the statutory requirements.

Subsection (a) (1) of Section 125 requires that bond interest be fully taxable.

Interest on the American Telephone and Telegraph bonds was fully taxable and the requirement of this subsection was satisfied.

Subsection (b) (1) requires that in determining the bond premium, the holder of *any* bond must use the basis (for determining loss on sale or exchange)

of such bond and the amount payable at the maturity or earlier call date.

Meeting this requirement, the respondent used the difference between the purchase price of $60,638.75 (his basis for determining loss) and the earliest call date price of $52,000, as the bond premium.

Subsection (b) (2) defines *amortizable* bond premium as the amount of the premium attributable to the taxable year.

The respondent purchased all of his bonds in 1944, and the earliest call date was also in 1944. The entire premium was therefore amortizable in the taxable year 1944.

Subsection (b) (3) provides that one method of computing amortizable bond premium is the method prescribed by the Commissioner.

The respondent followed the method prescribed by Section 29.125-5 of Regulations 111.

Subsection (c) (2) requires that a taxpayer who elects to amortize bond premium must be consistent in that he must amortize the premium on all bonds purchased at a premium and owned during the taxable year.

Respondent purchased or owned in 1944 only the American Telephone and Telegraph bonds, and amortized the bond premium on *all* such bonds.

Subsection (d) in effect excludes security dealers and traders from computing bond premium amortization under Section 125 on bonds held as stock in trade.

Respondent was not during the taxable year 1944 a dealer or trader in securities, but purchased the aforesaid bonds as an investment.

Under the law applicable to this case there can be no speculation as to whether bond premium is "true", "false"

or "quasi"; it can only be "statutory" bond premium. Respondent deducted the "statutory" bond premium in his 1944 return as he was permitted to do by Section 23(v) of the Internal Revenue Code.

This deduction is allowable without reference to the receipt by a taxpayer of gross interest earnings on bonds. If bonds become in default and the taxpayer receives no interest in the taxable year, nevertheless, having elected to amortize bond premium with respect to such bonds, he would be entitled to the deduction provided by statute. (Section 125(c) (2), Appendix, *infra*, p. 31).

Once an election to amortize is made it is mandatory thereafter to continue the deduction for amortization regardless of any resulting tax benefit or detriment to the taxpayer. For example, if a taxpayer has no income during the taxable year, the deduction for amortizable bond premium will produce no tax benefit. Nevertheless, under Section 113(b) (1) (H) of the Internal Revenue Code[6] the basis of his bonds would have to be reduced by the amount of such deduction. In the event of a later sale of the bonds this reduction in basis would increase the amount of gain (or decrease the loss) realized upon such sale. While,

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[6] "Sec. 113. * * *

"(b) Adjusted Basis.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

"(1) General Rule.—Proper adjustment in respect of the property shall in all cases be made.

* * * * * * *

"(H) in the case of any bond (as defined in section 125) the interest on which is wholly exempt from the tax imposed by this chapter, to the extent of the amortizable bond premium disallowable as a deduction pursuant to section 125 (a) (2), and in the case of any other bond (as defined in such section) to the extent of the deductions allowable pursuant to section 125(a)(1) with respect thereto."

under Section 117(b) of the Internal Revenue Code[7] only one-half of any gain on such sale would be recognized for tax purposes if the bond had been held for more than six months, this result is no different than in the case of an individual who realizes a profit on the sale of depreciable business property held for more than six months. (Section 117(j) of the Internal Revenue Code.)[8] In the latter case, just as in the case of the sale of the bonds, only one-half of the gain would be subject to tax despite the fact that the entire gain might result solely from a reduction in basis required to be made because of amounts previously allowed as deductions from ordinary income for depreciation.

The respondent has fully complied with the statutory provisions and is, therefore, entitled to the benefit of the deduction permitted by Sections 23(v) and 125 of the Internal Revenue Code.

White v. *U. S.*, 305 U. S. 281, 292;
New Colonial Ice Co. v. *Helvering*, 292 U. S. 435, 440.

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[7] "Sec. 117 • • •

"(b) Percentage Taken Into Account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months."

[8] Sec. 117

"(j) • • •

(2) General Rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business • • • held for more than 6 months • • • exceed the recognized losses from such sales, exchanges, • • • such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months • • •"

Even if the record in this case should show, which it does not, that respondent was motivated by a tax saving purpose, he is nonetheless entitled to the full benefits permitted by the law.

U. S. v. *Cumberland Public Service Company* (United States Supreme Court, No. 214—October Term 1949, decided January 9, 1950).

Section 125 sets forth a simple rule for determining the existence and amount of bond premium and the amortizable portion thereof. The application of this rule does not require any finding or determination as to the various factors which might cause bonds to sell at a premium. Congress thereby made it unnecessary to resort to "narrow and quite possibly unfair distinctions between varying bond issues" (R. 20). In so doing Congress wisely avoided the difficulties that would have been inherent in the administration of a statute which attempted to incorporate petitioner's concept of "true bond premium" with "sufficient precision so that it could safely be relied on by taxpayers or revenue enforcing authorities" (R. 20).

The words of the statute here involved are plain and unambiguous. Under such circumstances, a court is not at liberty to add to or to alter them to effect a purpose which does not appear on its face or which varies from its legislative history.

Matson Navigation Co. v. *U. S.*, 284 U. S. 352, 356;
Corona Coal Co. v. *U. S.*, 263 U. S. 537, 540.

POINT V.

The convertible bonds here involved are within the purview of Section 125 of the Internal Revenue Code.

The petitioner concedes that convertible bonds are within the scope of Section 125 (R. 29).[9] Nevertheless he takes the position that with respect to the convertible bonds here involved the statute does not apply for the same reason as urged elsewhere throughout his brief for the disallowance of the amortization deduction, viz., that the premium paid was not "true bond premium" (Pet. Br., p. 29).

As is plainly demonstrated by the preceding analysis of the statutory provisions involved, Congress did not require as a condition of premium amortization that the premium must result from some particular value creating factor, but instead provided simply that the amount of bond premium is the difference between cost and the amount payable at maturity or earlier call date. It is also clear that the intention of the statute is to permit the amortization of premium on convertible bonds. The only condition imposed is that the option to convert rest with the owner of the bond. This is made convincingly clear from the identical language appearing in both the House and Senate Committee Reports as follows:

> "The fact that a bond is callable or convertible into stock does not of itself prevent the application of this section. In the case of a callable bond, the earliest call date will, for the purposes of this section, be considered as the maturity date. Hence, the total premium is required to be spread over the

[9] Petitioner also raises no question with respect to respondent's right to amortize the premium on the American Telephone and Telegraph bonds to the earliest call date (R. 20; Pet. Br., p. 5).

> period from the date as of which the basis of the bond is established down to the earliest call date, rather than down to the maturity date. In the case of a convertible bond, *if the option to convert the bond into stock rests with the owner of the bond, the bond is within the purview of this section*" (Italics supplied).
>
> H. Rep. No. 2333, 77th Cong., 2d Sess., p. 80 (1942-2 CB 372, 433-434); S. Rep. No. 1631, 77th Cong., 2d Sess., p 94 (1942-2 CB 504, 576).

The statute incorporates the legislative intent expressed above by providing without qualification that the rules prescribed by Section 125 apply "In the case of any bond" (subsection (a)), and "in the case of the holder of any bond" (subsection (b) (1)).

The term "bond" is defined in subsection (d) of Section 125 as "* * * any bond, debenture, note, or certificate or other evidence of indebtedness * * *."

Subsection (d) further provides that the term "bond" as defined therein "does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

It was stipulated and found as a fact by the Tax Court that the bonds here involved are not within the foregoing exclusion (R. 2-3, 9-10).

Since there is no exclusion in the statute other than that contained in subsection (d) the maxim "*expressio unius est exclusio alterius*" applies. *Jones v. Crosswell*, (4th Cir.), 60 F. (2d) 827, 828.

The bonds here involved fall squarely within the statutory definition and there is no justification whatever for the petitioner's attempt to deny respondent the right to deduct the premium paid thereon.

CONCLUSION.

The decision of the Court of Appeals for the Second Circuit is correct and should be affirmed.

Respectfully submitted,

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Appendix.

Internal Revenue Code:

SEC. 23 DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(v) [as added by Sec. 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Bond Premium Deduction.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

* * * * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 125 [as added by Sec. 126 of the Revenue Act of 1942, *supra*]. AMORTIZABLE BOND PREMIUM.

(a) *General Rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b) on the bond for any taxable year beginning after December 31, 1941):

(1) *Interest wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) *Interest wholly tax-exempt.*—In the case of any bond the interest on which is excludible from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) *Adjustment of credit in case of interest partially tax-exempt.*—In the case of any bond the interest on which is allowable as a credit against net income, the credit provided in section 25(a) (1) or (2), or section 26(a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year.

(For adjustment to basis on account of amortizable bond premium, see section 113(b) (1) (H).)

(b) *Amortizable Bond Premium.*—

(1) *Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the ta payer with respect to such bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

(c) *Election on Taxable and Partially Taxable Bonds.*—

(1) *Eligibility to elect, and bonds with respect to which election permitted.*—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

(A) *Partially Tax-Exempt.*—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 25(a) (1) or (2) is allowable; and

(B) *Wholly Taxable.*—In the case of any taxpayer, bonds the interest on which is not excludible

from gross income but with respect to which the credit provided in section 25(a) (1) or (2), or section 26(a), as the case may be, is not allowable.

(2) *Manner and effect of election.*—The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such election. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the partnership only by the partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

(d) *Definition of Bond.*—As used in this section, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business (26 U. S. C. 1946 ed., Sec. 125).

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.125-1. *In General.*—(a) *Application.*—Section 125 makes provision for the amortization of bond premium by the owners of the bonds. It is mandatory with respect to—

* * * * * *

It is optional, at the election of the taxpayer, with respect to—

(1) fully taxable bonds (the interest on which is subject to normal tax and surtax), whether the owner is a corporation, individual, or other taxpayer, and

(2) partially tax-exempt bonds owned by taxpayers other than corporations.

The term "bond" as used in section 125 means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivisions thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Since bonds owned by dealers in securities are excluded from the foregoing definition, section 125 has no application to such dealers.

(b) *Operation.*—In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bonds. Thus, if such premium is $1, the basis or adjusted basis of the bond is reduced by $1. No deduction is allowable on account of such amortizable bond premium. In the case of a fully taxable bond to which section 125 is applicable, the amortizable bond premium is both an adjustment to the basis or adjusted basis of the bond and a deduction.

* * * * * *

SEC. 29.125-2. *Bond Premium and Amortizable Bond Premium.*—Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. (For determination of applicable call date see section 29.125-5.) If the date as of which such basis of the bond was established precedes the first taxable year with respect to which such section applies to the bond, there shall be made adjustments proper to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 117 (h)) prior to the date as of which section 125 first becomes applicable to the bond in the hands of the taxpayer.

* * * * * * *

Amortizable bond premium on any bond to which section 125 applies is such part of the bond premium on the bond as is attributable to the taxable year.

SEC. 29.125-3. *Methods of Amortization.*—The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(a) the method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(b) the method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning prior to January 1, 1942; or if for taxable years beginning on or after such date the taxpayer (including a taxpayer who followed a different method in taxable years beginning prior to January 1, 1942) initiates in the first taxable year for which the deduction is taken a reasonable method of amortization and consistently follows such method thereafter. A taxpayer who regularly employs a method of amortization may be one, for example, who is subject to the jurisdiction of a State or Federal regulatory agency and who, for the purposes of such agency, amortizes the bond premium on his bonds in accordance with a method

prescribed or approved by such agency. However, it is not necessary that the taxpayer be subject to the jurisdiction of such an agency or that the method be prescribed or approved by such agency. It is sufficient if the taxpayer regularly employs a method of amortization and if such method is reasonable.

The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with section 29.125-2 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this section a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

SEC. 29.125-4 *Election.*—In the case of a corporation, the election provided in section 125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall

apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. * * *

SEC. 29.125-5. *Callable and Convertible Bonds.*—The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium. A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof.